IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-584

RESEARCH EQUITY FUND, INC.,

Petitioner,

v.

THE INSURANCE COMPANY OF NORTH AMERICA,

Respondent.

BRIEF OF INVESTMENT COMPANY INSTITUTE, *AMICUS CURIAE*, IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Preliminary Statement—Interest of Investment Company Institute

This brief is submitted, with the consent of the parties,* by the Investment Company Institute ("ICI") as *amicus curiae* in support of the petition of plaintiff Research Equity Fund, Inc. for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit.

ICI, a voluntary association headquartered in Washington, D. C., is the national association of open-end investment companies (or "mutual funds", as they are

* Letters from counsel of record for the parties, expressing their consent to ICI's submission of *amicus curiae* briefs, are reproduced in the Appendix to this brief.

commonly known), their advisers and underwriters. ICI has 487 investment company members having approximately 7 million shareholders and assets of approximately $65 billion, which is about ninety per cent of the total assets of the mutual fund industry. All of the mutual fund members of ICI are registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq.* ("Act"). The decision of the Court of Appeals, if allowed to stand, would have an adverse impact upon ICI's investment company members and their 7 million shareholders.

Statement of the Case and Question Presented

Like most of the mutual funds in this country, petitioner Research Equity Fund, formerly known as Winfield Growth Fund, Inc. ("Fund"), has no salaried employees of its own, but is managed pursuant to contract by a separate investment advisory or management company. The manager, Winfield & Co. ("Manager"), is charged with the responsibility of managing the Fund's securities portfolio and, in addition, furnishes to the Fund such administrative services and personnel as the business of the Fund may require. All Fund officers were also officers of the Manager. (8a)*

Section 17(g) of the Act and SEC Rule 17g-1 require the Fund to maintain a fidelity bond to protect the Fund and its shareholders against larceny and embezzlement by its officers and employees. (2a) Petitioner purchased such a bond and suffered loss when a portfolio manager employed by the Manager was bribed to purchase securities whose prices had been inflated by manipulation. (2a-3a)

* Citations to "—a" are to the designated pages of the Appendix to the Petition for a Writ of Certiorari.

The Court of Appeals apparently ruled that the Fund's fidelity bond was a "statutory bond" and therefore had to be interpreted to provide the fidelity coverage mandated by the Act. (7a)

The question presented on these facts is whether a management company employee, who manages the portfolio of a mutual fund which has no employees of its own, is a fund employee within the meaning of Section 17(g) and SEC Rule 17g-1, and hence a person as to whom the Act mandates fidelity coverage.

Statement of the Facts

A. Stephen Sanders, who was employed directly by the Manager, acted as portfolio manager for the Fund, with the responsibility for deciding which securities should be purchased or sold for the Fund's portfolio. (2a) Sanders acted under the immediate supervision of an individual who was an officer of both the Fund and the Manager. (2a) During the period from December, 1969, through March, 1970, Sanders accepted bribes for recommending the Fund's purchase of certain securities at prices he knew to be artificially inflated as a result of manipulation. The Fund suffered losses in selling the securities after the scheme was discovered. (2a-3a)

As required by Section 17(g) of the Act and SEC Rule 17g-1,* the Fund maintained fidelity insurance bonds against losses resulting from dishonest acts by Fund officers and

* In Section 17(g), 15 U.S.C. § 80a-17(g), Congress conferred specific authority upon the SEC to adopt rules for the protection of investors requiring:

> ". . . that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company,

(footnote continued on following page)

employees who have "authority . . . to direct generally the disposition of [its] securities". Respondent Insurance Company of North America ("INA"), the issuer of the bonds—which were in the standard form issued to stockbrokers, investment bankers and mutual funds throughout the industry—denied coverage for the Fund's losses and the Fund instituted the present action. (3a, 17a)

The District Court concluded that the bonds did not cover the losses and dismissed the action. (49a) The District Court's judgment was affirmed by the Court of Appeals on the basis of two holdings: (1) that the losses were excluded from coverage by the plain meaning of the standard "trading loss exclusion" contained in the bonds (5a-6a); and (2) that even if the bonds were "statutory bonds" and hence should be interpreted to afford the coverage mandated by statute, Section 17(g) and Rule 17g-1 do not require coverage of losses resulting from the dishonesty of persons, such as Sanders, who are not officers of or employed directly by a mutual fund, but rather are employed by the fund's manager (7a-10a).

(footnote continued from preceding page)

> either directly or *through authority to* draw upon such funds or *direct generally the disposition of such securities* be bonded . . . against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe." (Emphasis supplied)

The SEC implemented this Congressional grant of authority by promulgating Rule 17g-1, which requires, in pertinent part, that:

> "Each registered management investment company shall provide and maintain a bond . . . against larceny and embezzlement, covering each officer and employee of the investment company, who may singly, or jointly with others, have access to securities or funds of the investment company, either directly or *through authority to* draw upon such funds or to *direct generally the disposition of such securities*. . . ." 17 C.F.R. § 270.17g-1 (Emphasis supplied)

Reasons for Granting the Writ

The Decision Below Undermines an Important Protection Which Congress Intended to Guarantee to Mutual Fund Shareholders by Violating the Act's Plain Language and Manifest Purpose, and Ignoring the Management Structure Prevailing Throughout the Mutual Fund Industry.

A. Statutory Language

If the decision of the Court of Appeals is allowed to stand, it would substantially erode a significant protection mandated by Congress for the millions of persons—largely of ordinary means—whose savings are invested in mutual funds. A mutual fund's business is the management of its portfolio. The Fund here suffered losses because of the dishonesty of its portfolio manager. It defies common sense to hold, as the Court of Appeals did, that Congress did not intend such losses to be covered because the thief was technically not an employee of the Fund in that his salary was paid by the Manager rather than directly by the Fund.

As the Second Circuit held in *Index Fund, Inc.* v. *Insurance Co. of North America*, 580 F.2d 1158 (1978), *cert. den.*, 99 S. Ct. 1226 (1979)—and as the Court of Appeals below apparently concurred (7a)—a fidelity bond of the type at issue here must be construed to provide coverage coextensive with that mandated by Section 17(g) of the Act and Rule 17g-1.* Rule 17g-1 describes the individuals required to be covered by mutual fund fidelity bonds as follows:

> ". . . each officer and employee of the investment company, who may singly, or jointly with others, have access to securities or funds of the investment com-

* The Second Circuit specifically held that a bond's "trading loss" exclusion does not insulate respondent insurer from liability if Rule 17g-1 mandates coverage for the losses sustained.

pany, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities. . . ."

Since neither the Rule nor the Act defines the term "employee", the term must be given its common-sense meaning. A mutual fund portfolio manager is a fund employee whether or not his salary is paid directly by the fund, and whether or not he is also an employee of the fund's manager. It is well established that the same individual can be subject to the supervision, direction and control—and hence be the "employee"—of more than one entity.* *E.g., Peters* v. *United Studios, Inc.*, 98 Cal. App. 373, 379, 277 P. 156 (1929); *Parke-Bernet Galleries, Inc.* v. *Franklyn*, 26 N.Y.2d 13, 18-19, 308 N.Y.S.2d 337, 256 N.E.2d 506 (1970). Here, because Sanders, in his role as Fund portfolio manager, was subject to the supervision, direction and control of the Fund's Board of Directors, he was a Fund employee. (2a)

The only limitation upon the term "employee" which is imposed by Rule 17g-1 concerns the authority of the employee with respect to a mutual fund's securities or cash. As portfolio manager for the Fund, "with authority to direct generally the disposition" of its securities, Sanders was a Fund employee under the meaning of Rule 17g-1.

B. Statutory Purpose

The importance of the case is also manifest in the fact that theft by portfolio managers is precisely the kind of conduct against which the Act intended to protect mutual fund shareholders. In the Findings and Declarations of Policy contained in Section 1 of the Act, Congress stated:

* This principle is recognized by Section 17(g) itself, which expressly excludes from its scope an "officer or employee [who] has such access [to a mutual fund's securities or cash] solely through his position as an officer or employee of a bank"; *i.e.*, the statute recognizes that a person who is an employee of a bank can also be an employee of a mutual fund.

"Upon the basis of the facts disclosed by the record and reports of the Securities and Exchange Commission . . . and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * *

"[W]hen investment companies are organized, operated, managed, or *their portfolio securities are selected, in the interest of directors, officers, investment advisers, or other affiliated persons* thereof . . . rather than in the interest of all classes of such companies' security holders." Act, Section 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (Emphasis supplied)

Congress implemented that policy by a number of interrelated prohibitions. Thus, Sections 17(a), (d) and (e) of the Act, 15 U.S.C. § 80a-17(a), (d), (e), generally prohibit mutual fund employees and others from engaging in transactions with the fund except in precisely enumerated circumstances. Section 17(f), 15 U.S.C. § 80a-17(f), requires that a mutual fund maintain its assets in the custody of a bank or other qualified institution. Other provisions of the Act require that "disinterested" directors, not affiliated in any way with a mutual fund's manager, constitute a majority or significant minority of the fund's board of directors and delegate specific "watchdog" responsibilities to the disinterested directors. Section 10(a), 15 U.S.C. § 80a-10; *see Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977), *cert. den.*, 434 U.S. 934; *Fogel* v. *Chestnutt*, 533 F.2d 731, 749 (2d Cir. 1975).

But since a clever thief can at times deceive even the most alert watchdog, Congress provided in Section 17(g) that fund shareholders were also to be protected by fidelity bonds. It is readily apparent from the scheme of the Act that Congress intended the bonding protection mandated by Section 17(g) to cover the dishonest acts of all those pos-

sessing authority to direct the disposition of a mutual fund's securities or money, regardless of whether such persons are technically employed by a mutual fund or are employed instead by the fund manager.

C. Management Structure Prevailing Throughout Mutual Fund Industry

If allowed to stand, the Court of Appeals' erroneous decision would have a pervasive adverse impact upon the mutual fund industry and mutual fund shareholders. As the Court of Appeals recognized, most mutual funds in the United States, like petitioner Fund, are managed externally, that is by separate investment advisory or management companies. (8a) Most mutual funds have no employees of their own and delegate the day-to-day management functions to a separate management company. Thus, the Second Circuit said in *Tannenbaum* v. *Zeller,* 552 F.2d 402, 405 (1977), *cert. denied,* 434 U.S. 934:

> "The mutual fund industry is in many ways unique, which in part explains the specific federal regulatory legislation concerning it. A mutual fund is a 'mere shell,' a pool of assets consisting mostly of portfolio securities that belong to the individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, an independent entity which generally organizes the fund and provides it with investment advice, management services, and office space and staff. The adviser either selects or recommends the fund's investments and rate of portfolio turnover, and operates or supervises most of the other phases of the fund's business. The adviser's compensation for these services is a fee which is usually calculated as a percentage of the fund's net assets, and thus fluctuates with the value of the fund's portfolio."

See *Burks* v. *Lasker,* 99 S.Ct. 1831, 1838 (1979); *Fogel* v. *Chestnutt,* 533 F.2d 731, 734-35 (2d Cir. 1975); REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H. R. REP. 2337, 89th Cong., 2d Sess. 45-47, 49-50 (1966).

The Court of Appeals sought to support its reasoning by noting that Congress was aware of the unique structure of the mutual fund industry and by ascribing significance to Congress' failure to require fidelity bonds for investment advisers registered under the Investment Advisers Act, 15 U.S.C. § 80b-1, *et seq.* (8a-9a) That failure has no significance here, for when Section 17(g) of the Investment Company Act was enacted in 1940, at the same time that the Investment Advisers Act was enacted, investment advisers whose sole business was the management of mutual funds were exempt from regulation under the Investment Advisers Act. Section 203, 54 Stat. 850 (1940). That exemption was not repealed until 1970. 15 U.S.C. § 80b-3(b)(2), amended by Pub. L. 91-547, § 24(a), 184 Stat. 1430 (1970). Thus, nothing in the history of the Investment Company Act or its amendments supports the constrictive definition which the Court of Appeals gave to the term "employee".

A far more plausible definition was given by the SEC as long ago as 1941, when the SEC General Counsel issued an opinion* to the effect that attorneys on general retainer from a mutual fund are "employees" of the fund, as that term is used in Section 10(a) of the Act, which at the time prohibited a mutual fund from having a board of directors of which more than sixty percent were "employees" or persons in other specified relations to the fund. The SEC's General Counsel expressed the view that the term "employee" "must be interpreted in light of the purpose of the particular section and the evil sought to be remedied thereby." Since the intention of Section 10(a) was to insure

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* Investment Company Act Release No. 214 (Sept. 15, 1941), (CCH) Fed. Sec. L. Rep. ¶ 48,032.

that at least forty percent of the board was independent of the mutual fund's management, and since counsel employed on a general retainer was "so closely related to the management that he cannot be considered to be the 'independent' type of person which the Act contemplates," counsel was not to be considered an "independent" director of the fund.

If the term "employee" in Section 17(g) of the Act is also defined "in light of the purpose of [the Act] and the evil sought to be remedied thereby", it is obvious that such term must include persons like Sanders who perform the vital function of portfolio management—a mutual fund's central function, the dishonest performance of which it was the Act's specific goal to prevent.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Of Counsel

October 10, 1979

Of Counsel:
MATTHEW P. FINK,
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Investment Company Institute

APPENDIX

[Letterhead of SHARP, RANDOLPH & GREEN]

September 27, 1979

Sullivan & Cromwell
125 Broad Street
New York, New York 10004

Re: *Research Equity Fund, Inc.* v. *The Insurance Company of North America,* 9th Cir., No. 77-1467

Dear Sirs:

On behalf of Research Equity Fund, Inc., I hereby consent to the Investment Company Institute's filing a brief *amicus curiae* in the Supreme Court with respect to the petition for a writ of certiorari that Research Equity will file in the above case.

Sincerely yours,

/s/ A. RAYMOND RANDOLPH, JR.

A. Raymond Randolph, Jr.

Attorney for
Research Equity Fund, Inc.

AAR/st

[Letterhead of Swaner, Leslie & Deriman]

September 28, 1979

Nadine Strossen, Esq.
Sullivan & Cromwell
125 Broad Street
New York, New York 10004

Re: Certiorari Petition in the Supreme Court in *Research Equity Fund, Inc.* v. *The Insurance Company of North America*

Insured:	Winfield & Co., Inc.
INA File:	986 B 34 28 47
Our File:	52-242

Dear Ms. Strossen:

This will confirm our several telephone conversations this past week, wherein you advised that your firm represents the Investment Company Institute and you have been requested by your client to file an amicus brief at the certiorari stage, but that you need the consent of Insurance Company of North America, in lieu of making a Motion.

I have just received a letter from Attorney Randolph, representing Research Equity, confirming that if INA consents to the filing to such an amicus brief by Investment Company Institute, that counsel for Research Equity Fund, Inc., will in turn consent in writing to the filing of an amicus brief by the Surety Association of America.

While Mr. Randolph's letter goes to the filing of an amicus brief at the certiorari level only, I believe our understanding goes beyond that and if the Supreme Court grants certiorari, it is my understanding that Research Equity would

consent to a brief on the merits by Surety Association of America, provided INA consents to a brief on the merits by the Investment Company Institute.

If Mr. Randolph has any disagreement with that understanding, he should let me know immediately.

In any event, in light of my agreement with Mr. Randolph, this is INA's consent to the filing of an amicus brief at the certiorari stage in the above case by the Investment Company Institute.

Naturally, this approval is contingent upon your expeditious filing of the amicus brief so that there is no undue delay in these proceedings.

Incidentally, any copies of pleadings should be served on Robert A. Seligson, Esq., 300 Montgomery Street, San Francisco, California 94104, as well as this firm, as he is counsel of record in this matter.

Very truly yours,

/s/ Robert E. Leslie

Robert E. Leslie

REL:mr

cc: Mr. Robert R. Danner, INA
Robert A. Seligson, Esq.
A. Raymond Randolph, Jr., Esq.